No. 16308

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

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ESTATE OF MARY JANE LITTLE, Deceased, BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, Executors,

*Petitioner,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

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## PETITIONER'S REPLY BRIEF.

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## TOPICAL INDEX

## TABLE OF AUTHORITIES CITED

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### Argument.

The briefs of both parties acknowledge that there is no dispute as to the operative facts in the instant case. (Pet. Br. p. 5; Resp. Br. p. 15.) Their differences in position relate to the legal significance to be attached thereto for Federal income tax purposes.

Further, for lack of argument, it may be assumed that respondent has narrowed the legal issues by conceding the applicability of the following rules of law noted by petitioner in its brief.

(1) A grant of broad discretion to a trustee to allocate trust receipts to corpus or income, standing alone, does not constitute a direction in a trust instrument to apportion deductions for depreciation or depletion to the trustee.

From this it follows under the decision in *William Fleming, Trustee* (1941), 43 B. T. A. 229, affd. (C. C. A. 5, 1941), 121 F. 2d 7, that when, pursuant to such discretion, a trustee charges trust income, and credits reserves for amounts covering depreciation and depletion, the legal effect thereof is an allocation of trust income rather than an apportionment of deductions for purposes of applying subsections 23(l) and 23(m) of the Internal Revenue Code of 1939. (Pet. Br. Point I(a).)

(2) The term "trust income" as used in subsections 23(l) and 23(m) means net income, as defined by the Internal Revenue Code, before deductions for depreciation and depletion. (Pet. Br. Point I(c).)

(3) Congress establishes its own criteria in federal taxing matters and state law may control only when the federal taxing act by express language or necessary implications makes its operation dependent upon state law. (Pet. Br. Point III(b).)

Respondent's argument in support of the decision below is reduced to two propositions of law which are stated as follows:

(1) The Texas court's decision construing the provisions of the modified "Foster Will Trust" was a final adjudication of the rights of the parties thereunder and is controlling. (Br. p. 15.)

(2) The trust under which the apportionment of depreciation and depletion deductions was made and under which income was paid to and received by the taxpayer was the modified trust created by the trust agreement of 1944 and the will. (Br. p. 21.)

Respondent's stated propositions of law and the arguments advanced thereunder, as did the opinion of the Tax

Court, simply beg the basic question before this Court—whether, *for purposes of applying subsections 23(1) and 23(m) of the Internal Revenue Code,* the provisions of an instrument creating a testamentary trust, *i.e.,* a will, can be modified by an instrument of agreement among beneficiaries to which the deceased testatrix was not a party. Having assumed, without citation of any authority, that the federal taxing statute does permit reference to instruments extraneous to the will, respondent, as did the Tax Court, proceeds to the erroneous conclusion that Texas Court's adjudication of the rights of the parties, as to the *allocation* of trust income between life beneficiary and trustee, was equivalent, for federal tax purposes of an *apportionment* of the allowable deductions to the trustee.

Since the latter of the above two propositions stands or falls upon the validity or invalidity of the former, it is desirable to examine respondent's points of law in reverse order to that in which they appear in respondent's brief.

## I.

## Respondent Erroneously Contends That the Trust, Under Which Apportionment of the Deductions for Depreciation and Depletion Must Be Made for Federal Tax Purposes, Was the Modified Trust Created by the Trust Agreement of 1944 and the Will.

Both respondent (Resp. Br. 21) and the Tax Court [Tr. 40] are compelled to acknowledge that the will of Gloria D. Foster was the instrument which initially created the trust under consideration. It is then said to follow that the trust agreement of 1944 "modified" the Foster will trust and the instrument of modification thus

became an "integral portion of the instruments creating the trust." [Tr. 42.] (Resp. Br. 24.) This proposition of law has two aspects.

First: Could the trust agreement of 1944 modify the Foster will trust as a matter of local law?

Second: Even assuming the affirmative of the First proposition, can the trust agreement of 1944 be regarded as modifying the Foster will trust instrument for purposes of apportioning allowable deductions under the federal income tax statute?

Respondent's brief cites no authority in support of his position on either of the foregoing propositions. Indeed, he cannot because the authorities are contrary thereto.

**(a) Effect of the Trust Agreement of 1944 Under Local Law.**

Let us carefully consider what occurred. First, the will of Gloria D. Foster, deceased, contained provisions which created a testamentary trust. As the Tax Court found, "the will made no mention of the treatment of depletion and depreciation deduction as between income beneficiaries and the trust." [Tr. 30.] The will in two separate places provided that "the decision of the trustees as to what property is corpus and what property is income of my estate shall be final and binding upon all parties at interest hereunder." [Ex. 5-E, second and fifth pages.] The will also contained strict spendthrift provisions designed to preclude anticipation or disposition by any beneficiary of her interest in *either corpus or income*. [Ex. 5-E, par. 10.]

Gloria D. Foster's mother, Mary Jane Little, her mother-in-law, Mrs. Jeremiah Foster, and her sister-in-law, Evelyn Foster, were named the income beneficiaries; Ann Armstrong Knight and Marian Ralston Knight were

named the remaindermen to whom the corpus was to go after the death of Mary Jane Little.

After the will was admitted to probate in August, 1943, Mary Jane Little proposed to institute a will contest relying upon a prior will dated September 8, 1942. Such proceedings never went beyond the proposal stage as a compromise agreement was entered into by and between L. C. Webster and T. A. Knight, trustees under the will (First Parties), the two Knight girls (Second Parties), and Mary Jane Little (Third Party). This agreement dated September 20, 1944, is Exhibit 6-F herein, and will be referred to as the "Foster compromise agreement" to distinguish it from Exhibit 7-G herein, a trust agreement dated November 14, 1944. The two instruments, Exhibits 6-F and 7-G, are collectively referred to in the Tax Court's opinion and the briefs as the trust agreement of 1944.

Now, neither the Foster compromise agreement [Ex. 6-F] nor the trust agreement of November 14, 1944 [Ex. 7-G] by its terms even purports to change or modify the *provisions* of the Foster will trust for the simple reason that to have attempted to do so would have violated two controlling rules of local law.

The first rule which precluded modification of the Foster will trust with respect to the discretion conferred upon the trustees as to apportionment of trust receipts to corpus or income was the provision of section 26 of the Texas Trust Act, referred to at page 37 of petitioner's opening brief. That section made the grant of discretion to the trustees *by the will* controlling over the provisions of the Act.

The second rule which precluded modification of the *provisions* of the Foster will trust is the well established

rule of trust law to the effect that a trust cannot be terminated or its terms varied, by agreement of the beneficiaries of a testamentary trust and heirs contesting a will, where to do so would defeat in whole or in part the purpose of the testator in creating the trust. Scott in his work on trusts puts the rule this way:

> "If the will is contested, the court may approve a compromise under which in order to save the trust a part of the designated trust estate is surrendered.
>
> * * * * * * * *
>
> "Where the will provides for the creation of a spend-thrift trust, the beneficiaries cannot insist on receiving the property or a part of it free of trust, or insist on the creation of a trust under which their interests are alienable, *or otherwise vary the terms of the trust,* under the guise of a compromise agreement, merely because they wish to do so. The agreement must be submitted to the court for its approval, and the court will approve the agreement only if it is reasonably necessary for the protection of the interests of the beneficiaries." (Emphasis added.)

See III:

*Scott on Trusts,* 2d Ed. (1956), Sec. 337.6, p. 2465, *et seq.*

See also:

American Law Institute, *Restatement of the Law, Second, Trusts* 2d (1959), Sec. 337, (2) and Comments (1) and (o) thereunder.

The rule as expressed by the appellate court of Texas is, if anything, narrower than the rule in *Scott on Trusts*

and the *Restatement of the Law.* The Commission of Appeals of Texas has said:

> "* * * in short, if a trust is created for a specific purpose, and is so limited that it is not repugnant to the rule against perpetuities, and is in other respects legal, neither the trustees, nor the cestui que trust, nor his creditors or assignees can divert the property from the appointed purposes. Any conveyance whether by operation of law or by the act of any of the parties which disappoints the purposes of the settlor by diverting the property or the income from the purposes named would be a breach of the trust."
>
> *Hughes v. Jackson* (1935), 125 Tex. 130, 81 S. W. 2d 656.

Compare dictum in:

*Sayers v. Baker* (1943), 171 S. W. 2d 547.

The two cited rules of local law explain certain provisions in the trust agreement of 1944, and fortify the conclusion that in entering into the compromise the parties did not modify the provisions of the Foster will trust but rather agreed to act within its provisions in a specified manner.

The Foster compromise agreement [Ex. 6-F] provided that the trustees and the Knight girls were to attempt to secure a declaratory decree to the effect that the Knight girls' remainder interests were not subject to restrictions on alienation. If such a decree were obtained, the compromise agreement was to remain in force; if not, Third Party, Mary Jane Little, could at *her election* terminate it. [See Ex. 6-F, par. 2.] There is no record that any such decree was ever obtained. The trust agreement of

November 14, 1944, makes no such recital. Indeed, paragraph 11, of Section II of the trust agreement of November 14, 1944, recognizes that the conveyance by the Knight girls of their future interests in the corpus of the estate might not be effective to vest title thereto in the Mercantile National Bank at Dallas. [Ex. 7-G.]

Further, the Knight girls' legal disability to alienate their interests explains why the trustee under the trust agreement of November 14, 1944, was specifically declared therein to be holding "naked legal title" to such interests.

Lastly, neither of these instruments [Exs. 6-F or 7-G] purport to change the *provisions* of the Foster will trust insofar as they relate to the trustees' discretion in allocating trust receipts. It is expressly recognized in paragraph 4, page 3, of the trust agreement of November 14, 1944 [Ex. 7-G], that the will granted the trustee "broad discretion in determining what portion of receipts of the estate shall be *allocated* to corpus and what portion of such receipts shall be allocated to income of the estate." (Emphasis added.) The language which follows does not abrogate or modify the *provisions* of the Foster will trust at all. It is stated:

> "* * * and Third Party [the trustee bank] *in the exercise of such discretion* hereby undertakes to make this allocation at all times in accordance with the provisions of law applicable at the time without regard to such discretion so granted by the will." (Emphasis added.)

The quoted language cannot in any sense to considered a modification *of the provisions of the will.* What it says in so many words is, simply, that in acting *pursuant* to the provisions of the will the Bank, as trustee, agrees to allocate trust receipts to income and corpus under the

formula prescribed by the law of Texas. It is noteworthy that the instrument itself employs words referring to the allocation of trust receipts. It does not refer to any apportionment of deductions.

It is, therefore, clear that *by its own terms* the trust agreement of 1944 contained provisions for an allocation of trust income within the purview of the federal taxing act, as distinguished from provisions apportioning deductions thereunder.

**(b) Effect of the Trust Agreement of 1944 Under Federal Tax Law.**

Even if it be assumed that the trust agreement of 1944 had the effect under local law of modifying the Foster will trust, respondent has failed to establish that such agreement had the legal effect of modifying the provisions of the "instrument creating the trust" within the meaning of subsections 23(1) and 23(m).

Neither respondent nor the Tax Court cite any authority in support of their position. Respondent contents himself with the unsupported statement that the *trust* with which the statute is concerned is the "modified trust" arising from the trust agreement of 1944. (Resp. Br. 23.) Sight is lost completely of the implications and connotations of the statutory words "instrument creating" the trust where a will is involved.

Respondent states that petitioner "assumes throughout" that the relevant trust is that "originally created by the will of Gloria Foster." (Resp. Br. 22.) Petitioner's position is based upon far more than mere assumption. As petitioner was at pains to point out in its opening brief (pp. 20-21, 31-33), the Congressional choice of words was advisedly made and with sound reason.

It is respondent who assumes that the federal tax statute permits him and the Tax Court to go outside the "instrument creating" the trust and read into it the provisions of instruments to which the testatrix was not a party.

It is respondent who assumes that the word "creating" is equivalent in meaning to the word "constituting."

It is respondent who assumes that an instrument which creates a secondary trust of the interests of beneficiaries under a testamentary trust becomes, in legal effect, part of the instrument which creates the testamentary trust. The word "create" has no such connotations.

Whatever may be said of inter-vivos trusts, where a settlor reserves or grants power to modify or revoke, or may legally do so with the consent of the beneficiaries, such is not the case where testamentary trusts are concerned. A testamentary trust is *created* only by the will of the testator and though its provisions can be construed, they cannot be modified.

> *Commissioner v. Netcher* (1944), 143 F. 2d 480 at 487.

By the time a will becomes effective and a testamentary trust comes into being, the *provisions* of the instrument creating it are beyond amendment, modification, or revocation.

> *Scott on Trusts, supra;*
> *Hughes v. Jackson, supra.*

Respondent says "petitioner has introduced unnecessary confusion in the case by its emphasis on a later trust not related to the year in controversy or to the tax issues here involved." (Resp. Br. 15.)

We beg to suggest that if confusion has been introduced, it is respondent who may be thanked for it, not petitioner. Respondent seems unable to decide which trust is the trust the provisions of which are at issue.

On page 15 of respondent's brief it is stated:

> "The agreements under which the 'Foster will trust' was modified also provided for a later trust, to become effective upon the death of the taxpayer. This later trust is irrelevant to the present case, since it did not become effective during the taxable years involved, nor did its terms relate to the issues here."

On page 16 it is stated:

> "The taxpayer threatened to contest the will, and a contract and agreement was entered into in September, 1944, followed by a trust agreement in November, 1944, which created the new trust referred to above, and also modified the Foster will trust."

Here, one pauses to inquire, if the trust agreement of November, 1944, was effective after the death of the taxpayer (which is true by its terms) and after the taxable years here involved, and was therefore, "irrelevant to the present case," how could it "modify" the provisions of the testamentary trust?

Then on page 33 of respondent's brief:

> "To put it differently, although petitioner argues as though there were but the original trust, analytically and chronologically there were three. The first was the trust provided in the will of Gloria Foster. The second was created in 1944, by agreement of all the persons claiming an interest in the corpus. This second, under which the income here taxed was paid

and received, contained terms substantially different from those in the will, and the document confirmed the validity of the will only as so modified. The third trust, also created in 1944, was to become operative only on the death of the taxpayer."

Now just which trust was the source of the income at issue in this case? On pages 15-16 respondent argues that the third trust modified the testamentary trust. On page 23 he speaks as if the testamentary trust had been terminated and the income here involved were received by the second trust set up *by agreement* of persons claiming an interest in the corpus, which second trust contained "terms substantially different" from those in the will. Respondent then recognizes on page 23, as before, that the third trust was operative only after Mary Jane Little's death.

Then respondent, throughly confused, says on page 23:

"Whether we consider the trust here in question as being a separate trust from the original one, or a modification of the original one, we cannot know what 'the trust' was during the taxable years by looking at the will alone. The trust as set up by the will no longer existed in its original form."

Petitioner does not exemplify respondent's confusion to embarrass respondent. Quite the contrary, the intention is to emphasize the *difficulties* involved in identifying the correct trust because the federal tax law states that the apportionment of deductions is controlled by the "pertinent provisions of the instrument creating the trust," from which the income is derived. It does not permit resort to other instruments whereby heirs or beneficiaries establish secondary trusts dealing with their expectancies, or whereby they settle their differences by agreeing so to do.

Some of the confusion is obviated by a careful examination of the provisions of the Foster compromise agreement of September 20, 1944. [Ex. 6-F.] This document did not, as respondent states, create or set up a second trust. It was an agreement whereby the parties agreed to create, in the future, a second trust of which the *res* was to consist of the remainder interests of the Knight girls when, as and if such interests vested in them after Mary Jane Little's death.

We further allude to respondent's confusion in order to point up the fact that his argument assumes that the Texas Court *construed* a modified testamentary trust, which, as a matter of law, it did not and could not have done in the face of the provisions of the will and section 26 of the Texas Trust Act. (See Pet. Op. Br. p. 37.)

Which brings us now to respondent's first point in argument.

## II.

## Notwithstanding the Texas Court's Decision Was a Final Adjudication With Respect to Certain Rights of the Beneficiaries of the Foster Will Trust, That Decision Was Not Controlling in the Matter of the Apportionment of Income Tax Deductions Under the Federal Taxing Statute.

Respondent's first point in argument (Br. 15) is that the decision of the Texas court construing the provisions of the modified Foster will trust was a final adjudication of the rights of the parties thereunder and is controlling. Controlling that decision may have been in some respects; but that it controls the issues in this case respondent wholly fails to demonstrate.

It is a cardinal principle of construction that a statute, a court decree or a legal document will be interpreted, if

possible, so as to give the same a meaning which does not violate an established rule of law as against a construction which does violate such a rule.

Respondent asks this Court to interpret the Texas court's decree as holding that the provisions of the Foster will were altered by extraneous documents and as so altered contained a direction that the trustee apportion all deduction for depletion and depreciation to the trustee. Respondent's argument urges this Court to interpret the Texas court's decision in a manner which would violate the express provisions of the will, section 26 of the Texas Trust Act, and the established rules of trust law recognized in the authorities cited in Point I, *ante,* herein.

Petitioner concedes that the Texas court's decree was a final adjudication. Petitioner concedes that that court's decree adjudicated *certain* rights of the parties involved in the proceeding before it. Petitioner concedes that the cases cited on page 20 of respondent's brief stand for the proposition that so far as a state court's decree determines the property rights of parties under local law, such a decree is determinative as to such rights where the federal taxing statute expressly or by necessary implication makes its operation dependent on state law.

Thus in *Freuler v. Helvering* (1934), 291 U. S. 35, a state court decree determining what income was distributable under state law was held to be controlling as to what income was distributable within the meaning of the federal taxing statute. This case did not however, involve the application of the specific provisions of sections 23(1) and 23(m) governing the allowance of deductions now before this Court. In the *Freuler* case, what constituted "distributable" income was expressly made to turn on state law including an order of a court governing

the distribution. Since the amount of the distribution in that case was influenced by the question whether under state law the trustee should have deducted depreciation, the decree of the state court on the issue necessarily fixed that amount.

The case was decided, however, before the addition to the federal tax statute of the rules for apportionment of deductions which are at issue in this Court. The provisions of the federal tax statute, here involved, superimpose a federal question upon the determination of the Texas court though the latter be final as between the parties before it.

This very type of situation was involved in *Blair v. Commissioner* (1937), 300 U. S. 5, cited by respondent. (Resp. Br. 20.) In the *Blair* case an Illinois court construed a will upon the issue whether under Illinois law a trust beneficiary's interest was alienable, and decreed that it was. The Supreme Court, in reviewing a tax controversy arising out of the state court decision, held that the latter's decree holding the interest to be assignable was final *as to that question.* But Justice Hughes then proceeded to consider the further question whether the assignment, though valid under Illinois law, was effective to shift the tax upon the income from the assignor to the assignees. "That," he said, "is a federal question." (Op. p. 11.)

The case of *Gallagher v. Smith* (1955), 223 F. 2d 218 (C. C. A. 3d), does nothing to alter or note any exception to the rules in *Freuler* and *Blair.*

Conceding, as petitioner does, the rules in the above cases, does not dispose of the federal question before this Court. Finality on the matter of state law here decided by the Texas court is but a premise to the federal question,

not, as respondent urges, dispositive of it. It is necessary to determine first, precisely what the Texas court did decide; second, what the effect of the decision was on the federal question.

**(a) The Texas Court's Decision Did Not Amend or Alter the Provisions of the Will of Gloria D. Foster. Its Order Implemented Those Provisions.**

Careful scrutiny of the Texas court's decree reveals that it did two basic things pertinent to our inquiry here.

(1) It adjudged that Messrs. Webster, Goodell and Knight, during their administration,

> "Out of the proceeds of oil, gas and other minerals produced and sold by the estate * * * correctly and properly computed depletion, and *allocated* correct and proper amounts to corpus for depletion, as shown by their final account on file herein.
>
> "II.
>
> "Plaintiffs also *allocated* correct and proper amounts to corpus for depreciation * * * ." (Emphasis added.)

(2) The Texas court ordered that:

> "In determining the 'net income' of decedent's estate, defendant, Mercantile National Bank at Dallas, as Successor Trustee of the Estate of Gloria D. Foster, Deceased, in accordance with the law applicable to said estate at this time, and until otherwise directed by a court of competent jurisdiction, is authorized, required and directed to charge and set aside to corpus reserves for depreciation on oil and gas lease equipment and machinery, and depletion, in the following manner:

"(a) *Depreciation:* A reserve for depreciation on the oil and gas lease equipment and machinery belonging to said estate, commencing December 27, 1946, to be computed in the same manner and according to the same formula as the decedent did during her lifetime and as plaintiffs have done as shown by their final account, which reserve for depreciation shall be deducted from the proceeds of sales of runs of oil and gas produced by said estate subsequent to December 1, 1946, as set aside to corpus.

"(b) *Depletion:* Out of the proceeds of oil and gas runs produced and sold and to be produced and sold from each oil and gas lease subsequent to December 1, 1946, compute, charge and set aside to corpus 27½% of the gross proceeds of such sales of runs from each lease (but not to exceed 50% of the net income from such lease after deducting the expense and carrying charges of such lease, including depreciation, but not including depletion)."

Now, the Texas court's judgment and decree necessarily had to derive authority from one of three legal premises:

(1) A specific directive in the will. But this was impossible because, as the Tax Court found, "the will made no mention of the treatment of depletion and depreciation deduction as between income beneficiaries and the trust." [Tr. 30.]

(2) The provisions of section 33 of the Texas Trust Act. That statute, however, expressly provided that if the settlor of a trust grants discretion to the trustee to apportion trust receipts to corpus or income, such provision controls notwithstanding the provisions of section 33 of the Act.

(3) The proposition of law that by its undertaking in the trust agreement of November 14, 1944, the trustee was estopped to exercise the discretion granted it by the will in any manner other than in accordance with Texas Trust Act. This proposition of law is the only one which does not do violence to the provisions of the will, section 26 of the Texas Trust Act, and the authorities cited under Point I *ante*.

The Texas Court's decision contains not a single word which supports the theory that trust agreement of 1944 had the legal effect of altering or modifying the *provisions* of the will. But the decree does recognize that Messrs. Webster, Goodell and Knight could properly *allocate* portions of trust income between corpus and income beneficiaries representing depletion and depreciation on the one hand and *net* income of the other. Why? Because the will granted them discretion so to do. Further, the decree could and did direct the trustee bank to *allocate* trust income in such manner because the will granted the trustee such discretion and the trustee had agreed to exercise its discretion in said manner.

Thus if the Texas court's decree is given the only interpretation which does not violate recognized rules of local law, the conclusion is inescapable that its legal effect was to authorize and direct the trustee to *allocate* trust income between income beneficiaries and trustee in accordance with the trustee's undertaking so to do. This being its legal effect, how, then, is the federal question resolved?

**(b) The Effect of the Texas Court's Decree Upon the Federal Question Is That the Deductions for Depreciation and Depletion Must Be Apportioned Between Income Beneficiaries and Trustee on the Basis of the Trust Income Allocable to Each.**

Under the federal tax statute the apportionment of the deductions between income beneficiaries and trustee is made to turn *first* upon whether the testatrix provided for such an apportionment in her will. If not the apportionment *must* be made upon the basis that trust income (before depletion and depreciation) has been allocated by the trustee to each.

It has been demonstrated in Point I, *ante,* supported by controlling authority, that the will contained no provisions for the apportionment of such deductions either expressly, or by way of modification or alteration by extraneous instruments.

It has been demonstrated, also, that under the only legally acceptable interpretation of the Texas court's decree, what the trustee did during the taxable year before us was to *allocate* trust income between income beneficiaries and itself. This being so, the federal question is thereby resolved, since the federal tax statute requires the deductions to be apportioned in the manner which the taxpayer apportioned them in her return. (Pet. Op. Br. Point I, pp. 20-26.)

## Conclusion.

The decision of the Tax Court is erroneous and should be reversed.

Respectfully submitted,

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